On Compounding

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Opportunistic Value Investing

On Compounding

"Compound interest is the 8th wonder of the world. He who understands it, earns it. He who doesn't pays it."

– Albert Einstein

The topics covered in this whitepaper explore compounding, dollar-cost averaging, systematic investing, the importance of staying invested, and how investors in the wealth accumulation phase of their life may employ these powerful forces to further their goals.

Compounding

While taking investment advice from a physicist may not be the first place one looks, Einstein's work concerning the ever-expanding nature of the universe is the astrophysics equivalent of compounding. The concept of compound interest is straight forward: if you reinvest what you earn you will ultimately earn more assuming it is reinvested at a similar rate. This sort of math can be applied with precision to savings accounts, certificates of deposit (CDs), and performing fixed income investments. Within the realm of the stock market, the variability of returns makes such compounding calculations more difficult. This is why investors look to long-term average investment returns as a guide. While past performance cannot guarantee future results, it can serve as a guide, and the longer one's time horizon is, the more likely one will be to achieve results closer to those long-term averages. A well-diversified portfolio can be a great compounding tool. With investments in a variety of companies across sectors and around the world, as an investor you participate in those businesses with a claim on earnings and dividends.

Being Ready

While this makes sense in theory, as an investor the ups and downs of the market can be challenging to hold on through. Indeed, when stocks go on sale they do not generally garner as much interest as your favorite retailer's Black Friday special. These "sales" often come on quickly and can be spurred by shocks to the economic system, a specific sector, or a specific company. As value investors, we reject the idea that the volatility in a stock's day-to-day share price is the true measure of its riskiness. Rather, we consider the permanent impairment of capital – losing your investment – to be the chief risk we seek to avoid. A value investor's primary risk management tool is being disciplined about the price paid for a company, seeking a margin of a safety – a fair discount – to our estimate of its intrinsic value. As such, moments of panic can create the best opportunities to invest in a company. The Hudson Value Partners team looks at companies each day (those that we own and those that we do not) so that we are always preparing for the "pop quiz" that Mr. Market may give us.

Time is the Disciplined Investor's Best Ally

The terms "dollar-cost averaging" and "systematic investing" are phrases that simply mean consistently adding to your portfolio at a regular interval. By adding cash to your portfolio each month, you can remove the emotion of wondering "Do I buy stocks at these prices?" or "In this economy?" In making that monthly contribution, you pay your future-self first. Regular contributions allow the team at Hudson Value Partners to continually add to your portfolio, taking advantage of the "sales" (and everyday prices too) that Mr. Market gives us throughout each year.

Regular additions to your portfolio as you seek to build wealth harness the power of dollar-cost averaging and compounding. Many investors already practice this with contributions to their 401k or workplace retirement plan that come out of each paycheck. While it is always a good idea to periodically review the investment allocation of your retirement plan, few break from the pattern of contributing from each paycheck – what the market is doing that month is an afterthought. This discipline is part of what turns these retirement accounts into powerful wealth builders. These regular contributions (with no special terms or names for them attached) are the most tangible examples of the power of letting periodic investments compound for you. Whether saving for retirement, education, a new home, or to start a business, you can apply those same principles to your taxable investment accounts.

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Staying Invested

Statistics also confirm the importance of staying invested through the cycle. Time in the market will generally beat attempts to time the market. When you continually add to your portfolio, you are not just riding the market ups and downs, but taking advantage of them:

- The average bull market in stocks lasts 56 months.
- The average bear market in stocks lasts 28 months. [I]
- Going back to 1871, there has been no rolling 20-year period with a negative stock market return, and only 3% of rolling 10-year periods have ever had a negative return. [II]
- Since 1980, in 32 out of 43 years, the S&P 500 has had a positive return by year end, but the average intra-year decline was 14.3% at one point. [III]
- From January 2002 - January 2022 missing the best days in the market meaningfully reduced returns:

Missing the 10 best days reduced your average annualized return by 4.19%

Missing the 20 best days reduced your average annualized return by 6.89%

Missing the 30 best days reduced your average annualized return by 9.08%

- Making sure you are invested during those best days means hanging on during the worst days: 7 of the 10 best days in this 20-year period happened within two weeks of the 10 worst days. [IV]

Action Items

- ✓ If available to you, make sure you are contributing to your workplace retirement plan with each paycheck. If your employer has a retirement match – make sure you are contributing enough to the plan to get that match.
- ✓ Make your IRA Account annual contributions early in the year to maximize the potential time to compound in a tax-advantaged account.
- ✓ Set up a monthly contribution to your taxable investment account and pay your future-self first! [IV]

With these steps completed – you will improve your odds of success as a long-term investor, systematically buying stocks when they are on sale, growing your portfolio each month, and making sure you are invested to benefit from the all-important best days in the market.

Contact HVP today to set up a recuring contribution to your investment account – your future self will thank you!

[I] Oppenheimer, Peter C. The Long Good Buy (2020) pages 105 & 136.
[II] Ibid page 31.
[III] JP Morgan Asset Management Guide to the Markets (3/31/23) slide 15.
[IV] Ausenbaugh, Elyse The Case for (Always) Staying Invested (2/18/22).

Resources for Further Reading

The Long Good Buy by Peter C. Oppenheimer (2020)

Stocks for the Long Run by Jeremey Siegel (6th Edition 2022)

Center for Research in Security Prices (CRSP) - https://www.crsp.org/resources/data

Fama & French Data Library at the Dartmouth Tuck School of Business -
https://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html

Investor.gov Compound Interest Calculator -
https://www.investor.gov/financial-tools-calculators/calculators/compound-interest-calculator

Photographs

In celebration of the launch of our Greenwich, Connecticut office in March 2023, this whitepaper features photographs from coastal Greenwich.

Disclosure Information

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